CONNECTICUT VOICES FOR CHILDREN

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Testimony in Support of S.B. 443
Finance, Revenue, and Bonding Committee
March 21, 2021

Dear Senator Fonfara, Representative Scanlon, Senator Martin, Representative Cheeseman, and members of the Finance, Revenue and Bonding Committee:

Connecticut Voices for Children (CT Voices) **supports S.B. 443, "An Act Concerning the Tax Incidence Report, Tax Incidence Analyses and the Disclosure of Returns and Return Information."** Below, we review the reasons for our support, and we also provide several recommendations to strengthen the bill.

S.B. 443 Would Increase Tax Transparency

Increasing tax transparency is essential to making Connecticut's tax system fairer and—building on the analysis in our January 2022 tax report—Connecticut has four major tax transparency problems:

Connecticut had an eight-year gap between the 2014 and 2022 tax incidence reports and therefore policymakers had to rely on an increasingly out-of-date analysis for several years.

Connecticut's 2014 and 2022 tax incidence reports provide relatively limited information.

Connecticut provides no tax incidence analysis of proposed and passed tax legislation.

Connecticut provides no tax gap analysis.[i]

S.B. 443 would significantly increase tax transparency in addressing several of the above problems:

It would require the Department of Revenue Services (DRS) to provide a tax incidence report every two years, which would ensure that policymakers have an up-to-date analysis of how Connecticut's tax system unfairly burden working- and middle-class families.

It would require the DRS to provide additional information on how Connecticut's tax system unfairly burdens working- and middle-class families. This includes adding historical data, providing an additional analysis of the tax burden for the top five percent and top one percent of the income distribution, and providing additional demographic information by income decile (e.g., the percentage of taxpayers who are homeowners, married, have children).

It would require the DRS to provide a projection of tax incidence under current law and—at the request of the co-chairs of the Finance, Revenue, and Bonding Committee—an analysis of proposed legislation, both of which would ensure that policymakers have an up-to-date analysis of how Connecticut's unfair tax burden on working- and middle-class families is expected to change.

Recommendations to Strengthen S.B. 443 and Further Increase Tax Transparency

While we support S.B. 443 as written, we have three recommendations to strengthen the bill and further increase tax transparency.

We recommend requiring the DRS to include in the tax incidence report all taxes that generate more than $20 million in revenue. The 2022 tax incidence report includes four major tax categories: (1) the personal income tax, (2) the property tax, (3) sales and excises taxes, and (4) the corporation business tax. These tax categories exclude four taxes that were included in 2014 tax incidence report and that are still in effect: (1) the gross earnings tax, which is regressive; (2) the insurance tax, which is regressive; (3) the estate and gift tax, which is progressive; and (4) the real estate conveyance tax, which is regressive. As noted, S.B. 443 would allow the co-chairs of the Finance, Revenue, and Bonding Committee to request that the DRS provide a tax incidence analysis of any legislation that would impact tax revenue by more than $20 million. Using that same threshold, we recommend requiring the DRS to include in the tax incidence report any tax that generates more than $20 million in revenue. For example, in FY 20–21, the gross earnings (or public service companies) tax generated $255 million, the insurance tax generated $202 million, the estate and gift tax generated $303 million, and the real estate conveyance tax generated $375 million, meaning the $20 million threshold would cover the four taxes from the 2014 report that were excluded in 2022. It would also cover other taxes that were not included in the 2014 or 2022 report, such as the relatively new pass-through entity tax.[ii]

We recommend requiring the DRS to include in future tax incidence reports (1) an estimate of the impact of Connecticut's tax gap on the average effective tax rate by income decile, and (2) an estimate of the overall size of Connecticut's tax gap. The tax gap is the difference between the tax owed to the government and the tax collected. At the federal level, the Internal Revenue Service (IRS) highlights two key causes of the income tax gap: (1) "opaque income sources that accrue disproportionately to higher earners" (e.g., business income and rental income) and (2) the IRS' limited, decreasing resources to ensure tax compliance. As we show in our January 2022 tax report, the problem of a tax gap that primarily benefits the wealthy due to limited information reporting and limiting auditing is likely even greater in Connecticut than in the U.S. as a whole. This is because (1) Connecticut has a higher share of "opaque income sources that accrue disproportionately to higher earners," and (2), like the IRS, the DRS' staff has decreased considerably over the last two decades.[iii]

Confirming that the DRS' limited resources are contributing to a substantial tax gap in Connecticut, Deputy Commissioner John Biello explained at a public hearing this year,

> When we benchmark DRS to our peers, we are significantly lower … when it comes to our audit coverage rate. … Most of our peers are at around 3 percent of an audit coverage rate. What I mean by that is as a percentage of the total taxpaying population, most states are averaging about 3 percent, and even higher than that. We're right at about 1 [percent], and in some of our tax types we're even below 1 percent because of the … low numbers of auditors. … On average, an auditor generates about $800 per hour; it's anywhere between $800 to $1,000 per hour. So if you calculate that out through the average number of hours per year that an individual works, that'll tell you that they are probably in the range of $2 million or so per year per auditor that would be brought in. And we are certainly not even close to the full capacity because … we are so far below our peers. Yes, we do have the capacity at DRS for more auditors. And there would certainly be a very positive return on investment with those auditors.[iv]

The tax gap is related to tax incidence in two key ways addressed below.

If income is underreported, especially the "opaque income sources that accrue disproportionately to higher earners," the *real* average effective tax rate for the wealthy is lower than the *reported* average effective tax rate in the tax incidence report. The Treasury Department estimates that the misreporting rate for "opaque income sources that accrue disproportionately to higher earners" is 55 percent, compared to less than one percent for ordinary wage and salary income. As a result, the Treasury Department estimates that the top five percent of tax filers are responsible for more than 50 percent of the tax gap, and the top one percent of tax filers are responsible for nearly 30 percent of the tax gap. To understand the potential impact of the tax gap on the average effective tax rate estimate provided in the tax incidence report, consider three cases where the average wealthy family's *real* income ($3.1 million) is the same but its *reported* income varies:

- If the average wealthy family reports all of its income and therefore has no income tax gap, the *reported* effective income tax rate is 6.99 percent before applying tax credits and the *real* effective income tax rate is also 6.99 percent before applying tax credits.

- If the average wealthy family does not report all of its income and has an income tax gap of 14 percent (the size of the total federal tax gap), the family's *reported* effective income tax rate is 6.99 percent before applying tax credits but its *real* effective income tax rate is 6.01 percent before applying tax credits—a difference in the effective income tax rate of nearly one percentage point.

- If the average wealthy family does not report all of its income and has an income tax gap of 19 percent (the size of the federal income tax gap), the family's *reported* effective income tax rate is 6.99 percent before applying tax credits but its *real* effective income tax rate is 5.66 percent before applying tax credits—a difference in the effective income tax rate of 1.3 percentage points.

Put more generally, if the tax incidence report excludes an analysis of Connecticut's tax gap, it likely understates the unfairness of Connecticut's tax system.[v]

Policymakers could use revenue from closing or reducing Connecticut's estimated $2.6 billion income tax gap to fund several proposed tax reforms that would make the tax system fairer for working- and middle-class families. The FY 2022–23 budget funds 625 full-time positions in the DRS, down from 833 in FY 2000. If policymakers added 200 auditors, which would bring the overall staff level in the DRS back nearly to the level in 2000, that would generate an estimated $400 million in revenue based on the DRS' estimate of $2 million per auditor. To be sure, the return on investment (ROI) would eventually decrease as the number of new auditors increases. However, the DRS confirmed that it is "not even close to full capacity," and we estimate in our January 2022 tax report that Connecticut's income tax gap is likely significantly greater than $400 million. Specifically, when applying the percentage of the federal income tax gap to Connecticut—a reasonable starting point based on the preceding analysis and lack of an official estimate from the state—we estimate that the income tax gap in Connecticut is $2.6 billion (or 19.4 percent). Closing or reducing that gap through increased funding for the DRS would generate enough revenue to fund several major proposed tax reforms, such as creating the Connecticut child tax credit (CT CTC), expanding the Connecticut earned income tax credit (CT EITC), expanding and reforming the Connecticut property tax credit (CT PTC), and inflation indexing Connecticut's income tax, all of which would make the tax system fairer for working- and middle-class families.[vi]

We recommend requiring the DRS to develop the tax incidence report entirely in-house or release a report detailing the additional capacity that is necessary. S.B. 443 states that the "Commissioner of Revenue Services may enter into a contract with any public or private entity for the purpose of preparing the [tax incidence] report." We recommend requiring the DRS to develop the tax incidence report entirely in-house. If the DRS does not have sufficient capacity to do so moving forward, we recommend requiring the DRS to submit a report to the General Assembly that details the additional capacity that is necessary. Developing sufficient tax analysis capacity in-house has several benefits: (1) It would allow the DRS to develop a more detailed and consistent tax incidence report every two years. (2) It would ensure that the DRS has the ability to analyze proposed legislation as directed in S.B. 443. (3) It would provide additional resources for the DRS to analyze and reduce Connecticut's tax gap, which would generate substantial revenue.[vii]

Thank you for your consideration,

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References

[i] Patrick R. O'Brien. (2022). "Steps to a Fairer Tax System." Connecticut Voices for Children. See pages 54–63.

[ii] Patrick R. O'Brien. (2022). "Connecticut's 2022 Tax Incidence Report: A High-Level Overview and Comparison to the 2014 Report." Connecticut Voices for Children; Connecticut Department of Revenue Services. (2021) "Annual Report Fiscal Year 2020–2021."

[iii] Patrick R. O'Brien. (2022). "Steps to a Fairer Tax System." Connecticut Voices for Children. See pages 42–46.

[iv] Connecticut Finance, Revenue, and Bonding Committee. (2022). "Public Hearing, March 11, 2022." Discussion starts at the 1-hour mark.

[v] Patrick R. O'Brien. (2022). "Steps to a Fairer Tax System." Connecticut Voices for Children. See pages 42–46 and 52.

[vi] Patrick R. O'Brien. (2022). "Steps to a Fairer Tax System." Connecticut Voices for Children. See pages 42–46 and 72–74.

[vii] Patrick R. O'Brien. (2022). "Steps to a Fairer Tax System." Connecticut Voices for Children. See pages 42–46 and 54–63.